STATE OF WEST VIRGINIA

FIFTH INSTALLMENT OF THE
FULL PERFORMANCE EVALUATION
OF THE

WORKERS' COMPENSATION DIVISION

SPECIAL REPORT

Noncompliance with Primary Contractor Liability Law

OFFICE OF LEGISLATIVE AUDITOR
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June 8, 1997

The Honorable Larry Wiedebusch
State Senate
403 Fern Drive
Glen Dale, West Virginia 26038-1005

The Honorable Vicki Douglas
House of Delegates
1003 Chestnut Drive
Martinsburg, West Virginia 25401

Dear Cochairs:

Pursuant to the West Virginia Sunset Law, we are transmitting this Fifth Installment of the Full Performance Evaluation of the Workers' Compensation Division Special Report, which we will report to the Joint Committee on Government Operations, Sunday, June 8, 1997. The issue covered is "Noncompliance with Primary Contractor Liability Law."

Sincerely,

Antonio E. Jones

AEJ/wsc

Enclosure

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EXECUTIVE SUMMARY

This is the fifth report of the Legislative Auditor on the Full Performance Evaluation of the **Workers' Compensation Division**. The first four reports comprised a compliance review of recommendations Ernst and Young on management and financial issues. **This is a special report on the Workers' Compensation Division's noncompliance with the State's primary contractor liability law.**

ISSUE AREA 1: Workers' Compensation Division is in Noncompliance with Primary Contractor Liability Statute

West Virginia *Code* §23-2-1d outlines circumstances in which a primary contractor shall be held liable for the premium deposits, premium taxes, interest and penalties of a subcontractor (see Appendix A for §23-2-1d in its entirety). The section also delineates methods by which primary contractors can protect themselves from some of these liabilities.

Employer information and testimony from representatives of the Workers' Compensation Division show that the Division has not fully implemented the 1993 law. As of May 23, 1997, the Division has not billed a primary contractor for the obligations of a subcontractor. The Division is also in noncompliance with the part of the statute that requires the Commissioner of the Bureau of Employment Programs to notify registered primary contractors of the default status of their subcontractors.

CAUSAL FACTORS

There are four primary causes for the Division's failure to fully implement the primary contractor liability law. The first of these is that there are various complexities in complying with the law, such as multiple primary contractors for the same subcontractor and managing defaults on repayment agreements. Second, the replacement of the Division's information system made it difficult to justify modification of the legacy system. Further, the planning, development and implementation of the new information system, WCIS, required giving priority to certain other business functions. Third, the inaccuracy of employer account information made management "...hesitant to notify third parties regarding a specific employer's default status..." And lastly, the administrative rule to implement the law did not become effective until January 1, 1995.

EFFECTS

Not implementing the law has had the adverse effects of reducing Workers' Compensation collections from what is attainable; causing harm and inconvenience to primary contractors subject to Division of Environmental Protection regulation; and causing unnecessary expenses and inefficiencies for the Division of Environmental Protection.

CONCLUSION AND RECOMMENDATION

The Division is planning to acquire a higher level of compliance through its modification of a computer program which occurred on May 29, 1997, that will automate the generation and mailing of notices of default to registered primary contractors. In order for the Division to achieve full compliance, it will need to enforce the law by pursuing collections from the primary contractors of defaulted subcontractors, as mandated by statute. It is the opinion of the Legislative Auditor that the Division should also commit resources to enforcing the law on unregistered primary contractors, though the statute is ambiguous as to the Division's responsibility to do so.

OBJECTIVE, SCOPE AND METHODOLOGY

This full performance evaluation of the West Virginia Workers' Compensation Division was conducted in accordance with the West Virginia Sunset Law, Chapter 4, Article 10 of the *West Virginia Code*. A full performance evaluation is a means to determine for an agency whether or not the agency is operating in an efficient and effective manner and to determine whether or not there is a demonstrable need for the continuation of the agency. The evaluation will help the Joint Committee on Government Operations determine the following:

- if the agency was created to resolve a problem or provide a service;
- if the problem has been solved or the service has been provided;
- the extent to which past agency activities and accomplishments, current projects and operations and planned activities and goals are or have been effective;
- if the agency is operating efficiently and effectively in performing its tasks;
- the extent to which there would be significant and discernable adverse effects on the public health, safety or welfare if the agency were abolished;
- if the conditions that led to the creation of the agency have changed;
- the extent to which the agency operates in the public interest;
- whether or not the operation of the agency is impeded or enhanced by existing statutes, rules, procedures, practices or any other circumstances bearing upon the agency's capacity or authority to operate in the public interest, including budgetary, resource and personnel matters;
- the extent to which administrative and/or statutory changes are necessary to improve agency operations or to enhance the public interest;
- whether or not the benefits derived from the activities of the agency outweigh the costs;
- whether or not the activities of the agency duplicate or overlap with those of other agencies, and if so, how the activities could be consolidated;
- whether or not the agency causes an unnecessary burden on any citizen by its decisions and activities;
- what the impact will be in terms of federal intervention or loss of federal funds if the agency is abolished;

The evaluation of the Division covers the period of January 1, 1992 to the present. However, events prior to this period may be included when necessary. The evaluation included a planning process and the development of audit steps necessary to collect competent, sufficient and relevant evidence to answer the audit objectives. Physical, documentary, testimonial and analytical evidence used in the evaluation was collected through interviews, review of records, and site visitations.[1] The evaluation was conducted in accordance with Generally Accepted Government Auditing Standards (GAGAS) issued by the Comptroller General of the United States.

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[1] *Documentary evidence is created information such as letters, contracts and records. Physical evidence is the direct observation of the activities of people, property or events. Testimonial evidence consists of statements received in response to inquiries or from interviews, and analytical evidence includes the separation of information into components such as computations, comparisons and reasoning.*

Mission of the Workers' Compensation Division

...to accurately, fairly and promptly administer quality workers' compensation services through the collection of premiums from employers and the payment of benefits to injured workers and to dependents of fatally injured workers, with the intent of hastening the workers return to work.

The Workers' Compensation Division (WCD), codified in Chapter 23 of the *West Virginia Code,* was created in 1913 for the purpose of offering workers' compensation insurance. Initially an optional plan, the program became compulsory in 1974. The purpose of the program is "to provide workers with a simple method of securing immediate relief from the physical and economic effects of job related injury and disease." Further, the state is the sole provider of workers' compensation insurance. However, those employers that are eligible may opt to self-insure their workers' compensation risk. ***Although the Division is a public entity it operates like a private insurance company, collecting premiums, investing the funds, and paying benefits to injured workers making compensable claims.*** The Division administers several funds including the Workers' Compensation Fund, the Coal Workers' Pneumoconiosis Fund, Employers' Excess Liability Fund, the Disabled Workers' Relief Fund and a Surplus Fund which is made up of a Catastrophe Reserve, a Second Injury Reserve, and a Supersedeas Reserve. See APPENDIX 1 for fund administered by the Division. APPENDIX 2 contains an organizational chart of the Division.

The financial condition of the Division has eroded over many years. For FY 1989 the Division was believed to have a $404 million to $504 million deficit.[2] By FY 1996 the deficit was believed to be $2.2 billion. In 1990, the Division transferred $210 million declared to be an actuarially determined surplus from the Coal Workers' Pneumoconiosis Fund to the Workers' Compensation Fund. While the assets transferred cannot be used to satisfy the debts of the Workers' Compensation Fund until all other assets of the Fund have been expended, the interest earnings may be used for this purpose.

In 1991, Ernst and Young (E & Y) was engaged in a $45,000 contract by the Bureau of Employment Programs to audit the Workers' Compensation Division's financial statements for fiscal year 1991. In lieu of issuing financial statements for the Division, ***E & Y issued a draft management letter on March 16, 1992 that found the Workers' Compensation Division to have "an overall lack of internal controls resulting in what we [Ernst and Young] consider to be a pervasive material weakness situation..."*** E & Y defined a material weakness as

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[2] *Financial audits indicate the reliability of financial information pre-dating FY 1995 is highly suspect. In addition, a change in the methodology of calculating the estimated liability for unpaid claims beginning FY 1993 was made as required by GAAP. This new methodology increased the deficit, as reported, by over $565 million.*

> a reportable condition in which the design or operation of one or more of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and may not be detected within a timely period by employees in the normal course of performing their assigned functions.

The final draft management letter detailed the material weaknesses of the Division, which rendered the Division impossible to audit. In subsequent financial audits for FY 1993 and FY 1994, Ernst and Young continued to find the Division's records to be

> generally inadequate to produce reliable financial information with respect to premiums receivable from subscribers and self-insurers; premium advance deposits; and the estimated liability for unpaid claims and claim adjustment expenses, including contingent liabilities for self-insured employers who have defaulted or who may reasonably be expected to default. Additionally, weaknesses in the internal control structure are of an extent that cannot be overcome by auditing procedures.

Generally, the purpose of a financial audit is to provide the users of the resulting financial statements assurance that the financial statements do accurately represent the financial status of the auditee (an "unqualified opinion"). Because of the pervasive material weakness situation, E & Y was unable to express an opinion on the Division's financial statements. The 1993 and 1994 reports of E & Y also stated "the Division's recurring losses and deficit raise substantial doubt about its ability to continue as a going concern in its present form," meaning the Workers' Compensation Division would not be able to meet its obligations to claimants in the foreseeable future if problems were not corrected.

During the 1995 Legislative Session, the West Virginia Legislature passed S.B. 250 which made many reforms to the workers' compensation system. As a result of the legislation, the efforts of the management and employees of the Bureau and Division, and several consulting firms involved in the Division's Total Quality Initiative (TQI), the Workers' Compensation Division received its first unqualified audit opinion from Ernst and Young for fiscal year 1995. More importantly, the 1995 financial audit also marked the end of the "going concern" paragraph.

Because the 1992 Ernst and Young final draft management letter represents the most comprehensive and up-to-date independent audit of the Workers' Compensation Division, the Performance Evaluation and Research Division began a compliance review in audit year 1996-1997 to measure the Division's responsiveness to the E & Y recommendations. The review was not completed in 1996-1997 and is being continued in audit year 1997-1998. A total of 33 issues were addressed in the 1996-1997 report. The compliance review approach will enable us to evaluate the Division's progress toward reestablishing the security of the fund and resolving the unfunded liability. Other justifications for the selection of a compliance audit format include a desire not to duplicate the work Ernst and Young had already conducted, the 1992 final draft management letter's primary focus on management controls and the GAGAS standards requiring the following up of the work of other auditors. Excerpts of the GAGAS standards relating to the importance of management controls and the importance of checking compliance with previous audits have been included in TABLE 1.

TABLE 1
Generally Accepted Government Auditing Standards Relating to Management Controls and Compliance Reviews

Importance of Management Controls

6.39 Auditors should obtain an understanding of management controls that are relevant to the audit. When management controls are significant to audit objectives, auditors should obtain sufficient evidence to support their judgments about those controls.

6.40 Management is responsible for establishing effective management controls. The lack of administrative continuity in government units because of continuing changes in elected legislative bodies and in administrative organizations increases the need for effective management controls.

6.41 Management controls, in the broadest sense, include the plan of organization, methods, and procedures adopted by management to ensure that its goals are met. Management controls include the processes for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

Standards on follow up and work of others

6.12 Auditors should follow up on significant findings and recommendations from previous audits that could affect the audit objectives. They should do this to determine whether timely and appropriate corrective actions have been taken by auditee officials. The audit report should disclose the status of uncorrected significant findings and recommendation from prior audits that affect the audit objectives.

6.13 Much of the benefit from audit work is not in the findings reported or the recommendations made, but in their effective resolution. Auditee management is responsible for resolving audit findings and recommendations, and having a process to track their status can help it fulfill this responsibility. If management does not have such a process, auditors may wish to establish their own. Continued attention to significant findings and recommendations can help auditors assure that the benefits of their work are realized.

6.14 Auditors should determine if other auditors have previously done, or are doing, audits of the program or the entity that operates it. Whether other auditors have done performance audits or financial audits, they may be useful sources of information for planning and performing the audit. If other auditors have identified areas that warrant further study, their work may influence the auditors' section of objectives. The availability of other auditors' work may also influence the selection of methodology, as the auditors may be able to rely on that work to limit the extent of their own testing.

To assess and report on the degree of compliance by the Workers' Compensation Division with the findings and recommendations considered in the 1992 Ernst and Young final draft management letter, compliance measures have been adopted. These compliance measures are defined in TABLE 2.

TABLE 2 Levels of Compliance
In Compliance - The Division has corrected the problems identified in the final draft management letter.
Partial Compliance - The Division has partially corrected the problems identified in the final draft management letter.
Planned Compliance - The Division has not corrected the problem but has provided sufficient documentary evidence to find that the agency will do so in the future.
In Dispute - The Division does not agree with either the problem identified or the proposed solution.
Non-Compliance - The Division has not corrected the problem identified in the final draft management letter.

This installment of on the on-going Full Performance Evaluation is to detail a reportable finding that is outside the scope of the compliance review which is documented under separate cover. Other reportable findings falling outside the scope of the compliance review may be presented in a format similar to that of this report. This report represents the first of audit year 1997-1998 and the first special report outside the compliance review which began in audit year 1996-1997.

ISSUE AREA 1: Workers' Compensation Division is in Noncompliance with Primary Contractor Liability Statute

A well documented complaint from a surface mining company prompted an examination of the Workers' Compensation Division's implementation of its **primary contractor liability law**. In that case, the surface mining company received a Notice of Violation from the State's Division of Environmental Protection for having a defaulted subcontractor involved in coal removal. The primary contractor maintains that if the Workers' Compensation Division had met its statutory obligation to notify the primary contractor of its subcontractor's default status, its costly ordeal with the Division of Environmental Protection could have been avoided.

West Virginia *Code* §23-2-1d outlines circumstances in which a **primary contractor** shall be held liable for the premium deposits, premium taxes, interest and penalties of a **subcontractor** (see Appendix A for §23-2-1d in its entirety). The section also delineates methods by which primary contractors can protect themselves from some of these liabilities.

Primary contractors procuring services through subcontractors for periods longer than thirty days can be held equally liable for the premium deposits, premium taxes, interest and penalties of a subcontractor that were incurred by the subcontractor. A primary contractor may avoid this initial liability by obtaining a "certificate of good standing" for that subcontractor from the Workers' Compensation Division. In order to continue avoiding liability under this section, the primary contractor must provide a written request to the Commissioner of the Bureau of Employment Programs to be notified of any subsequent default by that subcontractor. The request for notification further limits the primary contractor's liability to that which is incurred beginning on the first day of the calendar quarter following the calendar quarter during which the primary contractor was sent notification.

CONDITION AND CRITERIA

The Workers' Compensation Division has not been complying with its statutory responsibility to notify such primary contractor of its subcontractor's default status when a request for the same has been submitted to the Division by the primary contractor. In cases where primary contractors have made written requests for notification of subsequent default of their subcontractors, West Virginia *Code* §23-2-1d requires that the Commissioner of the Bureau of Employment Programs "shall then notify the primary contractor of the default by placing a notice in the first class United States mail, postage prepaid, and addressed to the primary contractor at the address furnished to the commissioner by the primary contractor."

The Executive Director of the Workers' Compensation Division explained in a letter to the Performance Evaluation and Research Division of the Legislative Auditor's Office (see Appendix B),

*Since 1993 the Workers' Compensation Division has implemented compliance with West Virginia Code §23-2-1d (primary contractor liability) on a **gradual basis** as the Division's ability to properly administer the Code has improved (emphasis added).*

In an interview, the Supervisor of Accounts Management explained that the first request for notification came from one of the state's largest manufacturers. The Company had approximately 600 subcontractors. "We realized very quickly that we were not equipped to comply with the law." According to the Supervisor of Accounts Management, the Division started development of a program on the *legacy information system* to manage these notifications in 1993.

However, around the time the program was ready to use or after it had been in use for a short time, the conversion to WCIS began. For a while we were under the understanding that the law was going to be repealed because of the great difficulty and expense in implementing it. In more recent history, notification of default has been performed on a hit and miss piecemeal basis, with a few primary contractors being notified via a manual process. For the most part, we have not had a formal system for implementing these provisions.

As discussed earlier, Workers' Compensation may notify a primary contractor of a subcontractor's account status by two different methods. A **certificate of good standing**, as contemplated in statute, is intended to serve as initial notification to a primary contractor that a subcontractor is current on its account. A **notification of subsequent default** is to alert a primary contractor of any default occurring after the initial *certificate of good standing* is received by the primary contractor. The Workers' Compensation Division sends certificates of good standing for subcontractors to all primary contractors which have ever requested certificates of good standing for a subcontractor. While the statute does not require the Division to continue to send certificates of good standing to primary contractors, it does so as a means of compensating for the *notices of subsequent default* that are not being sent out. The Executive Director made the following statement in his letter to the Legislative Auditor's Office (Appendix B):

Since the conversion to WCIS™, primary contractors who register subcontractors with the Division do receive a certificate of coverage for all such identified subcontractors in good standing [each calendar quarter]. Accordingly, a primary contractor can deduce if a certificate is not received, additional inquires should be made of the subcontractor with regards to valid workers' compensation coverage.

While this is not what is contemplated in the statute, not receiving a *certificate of good standing* may indeed provide a red flag to primary contractors in some instances. However, the language requiring the Commissioner to notify primary contractors under the conditions set forth in statute is not permissive, but mandatory. More importantly, all of the primary contractor liability statute is mandatory. This means that the division should be pursuing collections from the primary contractors of defaulted subcontractors. According to the Supervisor of Accounts Management,

"To the best of my knowledge, ***Workers' Compensation has never billed a primary contractor for a subcontractor's default or delinquency*** *(emphasis added)."*

CAUSAL FACTORS

The Division's failure to implement all of the provisions of §23-2-1d has been driven by the following four primary causes: 1) the complexities in complying with the law; 2) the replacement of the Division's information system; 3) the inaccuracy of employer account information; and, 4) the administrative rule to implement the statute was not effective until January 1, 1995 and that version was replaced on January 19, 1996.

On the surface, implementation of the statute may seem elemental. However, there are several complex problems associated with its compliance. This exercise could be very labor intensive, and according to the Supervisor of Accounts Management, "...our information system is not equipped to handle it."

Another problem arises when defaulted employers are allowed to enter into repayment agreements to bring their accounts into good standing. In the event that a subcontractor misses a payment on a repayment agreement, the repayment agreement ends, and the subcontractor is retroactively liable for interest and penalties back to the first missed payment. If a primary contractor was to be liable for a subcontractor's debt it would not be forced to pay the entire amount, but would be liable for debt incurred for the quarter following the quarter in which the first notice was sent.[3] According to the Supervisor of Accounts Management, "This creates a bookkeeping nightmare."

Adapting the Division's information systems to handle the 1993 law is another task that further complicates implementation. The former information system, known as the *legacy system* required some modification to ease implementation of the law. While the current information system, WCIS or the Workers' Compensation Insurance System, has been entirely developed and implemented while the law has been in effect, the system is only now being programmed to facilitate the primary contractor liability law. The Division is planning to have a WCIS program ready by May 31, 1997, that will automatically send notifications of subsequent defaults to primary contractors on the Certificate Requestors/Notice Requestors screen.

The legacy system was modified to store primary contractor/subcontractor relationships. However, due to the planning of WCIS, more complex modifications of the legacy system were not pursued. In turn, WCIS is a much larger enterprise system than the legacy system, which further delayed any automated primary contractor liability functions.

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[3] This Scenario is for a primary contractor which received a *certificate of good standing* before any work was performed by the subcontractor and also registered for notification of subsequent default for that subcontractor. As discussed, the extent of the primary contractor's liability is contingent upon the primary contractor's diligence at the beginning of the contractual relationship.

Inaccurate employer balances, which were caused largely by the legacy system's inability to control for the quality and completeness of data made enforcement of the primary contractor liability law even more difficult. According to the Executive Director,

> *The Legacy computer system did not allow for the maintenance of accurate employer balances. Accordingly,* ***the Division was hesitant to notify third parties*** *regarding a specific employer's default status since the correctness of the default could not be ensured without an audit of the employer's account. In addition the man-hours capacity to audit each possible defaulted account prior to the scheduled mailing of default letters (a period of approximately five days) would have required a re-direction of efforts away from daily operations and other collection initiatives (emphasis added).*

Though §23-2-1d was effective April 8, 1993, upon passage by the Legislature, the administrative rule to implement the law, Code of State Rules §85-10, was not effective until January 1, 1995. Administrative rule §85-10 was replaced on January 19, 1996 with a version that incorporated the legislative changes of 1995. The delay in the development of the administrative rule could have contributed to the delay in implementing the primary contractor liability statute.

EFFECTS

The effects of not implementing the primary contractor liability law are significant. By not implementing §23-2-1d in its entirety the Workers' Compensation Division has caused 1) a reduction in Workers' Compensation collections; 2) harm and inconvenience to primary contractors subject to Division of Environmental Protection regulation; and 3) unnecessary expenses and inefficiencies for the Division of Environmental Protection. These effects are discussed in greater detail below.

The primary contractor liability law came into effect on April 8, 1993 with the passage of H.B. 2802. The bill created the Compensation Programs Performance Council and made many other sweeping changes to West Virginia's Workers' Compensation program. Article VII, section 5 of the *Constitution of West Virginia* requires that the executive branch "...shall take care that the laws be faithfully executed." As evidenced by the employer files and the testimony of Workers' Compensation Division representatives, the law had not been fully implemented as of May 9, 1997, over four years after its passage.

The law was passed to improve collection efforts. Subcontractors would now be subjected to pressure from their primary contractors should they find themselves in bad standing with the Workers' Compensation Division. In addition, the law allows the Division to recover moneys from primary contractors in the event the subcontractor fails to pay. As of May 9, 1997, the Division's records indicated that 114 subcontractors for which *certificates* and *notices of*

subsequent default status were requested by primary contractors were in default status. Of these 114 in default status, 153 primary contractors had requested either a *certificate of good standing* or a *notice of subsequent default* (or both) for one of these subcontractors. These numbers do not include the primary contractors and subcontractors which are not on the *certificate of good standing/notice of subsequent default* list. The latter primary contractors would bear greater liability than the primary contractors on the list, because they have failed to take the legal measures which would limit their liabilities. Primary contractors which did not request a *certificate of good standing* from the Division prior to the initial performance of any work by the subcontractor are to be liable for all of their subcontractors' Workers' Compensation obligations. It should be obvious that enforcement of the law would greatly enhance collection efforts.

There is a unique effect of the non-execution of the Division's statutory obligation to notify primary contractors of the subsequent defaults of their subcontractors. In upholding its statute, the **Division of Environmental Protection (DEP)** considers the Workers' Compensation default status of subcontractors during its monthly (or more frequent) inspections of surface mining operations, a primary contractor holding a mining permit can be given a Notice of Violation for a defaulted subcontractor. In nine instances between January 1997 and April 1997, Notices of Violation were served on permit holders by DEP inspectors for Workers' Compensation defaults. Of those nine instances, six were for defaulted subcontractors of the primary contractors which held the mining permits. Of those six cases in which a primary contractor's mining permit was jeopardized by the default of a subcontractor, one case involved a primary contractor which requested a notification of subsequent default from the Workers' Compensation Division and did not receive the same. In that case the subcontractor came into default seven months before the DEP Notice of Violation was issued. If the Workers' Compensation Division had notified the primary contractor of the subcontractor's default as required by law, the primary contractor may have been able to coax the subcontractor into coming into good standing before the DEP got involved.

The Notice of Violation process can produce serious consequences. DEP's policy is to allow the permit holder 30 days to correct the problem (DEP can provide up to 90 days) . The permit holder can either elect to retain the subcontractor if it comes into good standing with Workers' Compensation or fire the subcontractor. If the permit holder fails to remedy the situation, a Cessation Order can be issued by the DEP. The Cessation Order prohibits any mining activity at the site. The Cessation Order remains in effect until a Show Cause Hearing. At the Show Cause Hearing it will be determined if the permit holder will be allowed to retain its mining permit. Of course this is legal process with many possible variations and opportunities for appeals to the Board of Review at virtually every stage of the process.

In the case cited above, the company was faced with a $70 fine which was reduced to $0 by the DEP Assessment Officer. The company was still faced with having to correct the problem in 30 days. It did correct the problem. However, if the Workers' Compensation Division had notified the primary contractor when the default occurred, the expense and inconvenience of the process could have been avoided and the Workers' Compensation Division could have collected this obligation sooner.

CONCLUSION

The Workers' Compensation Division is planning to test a computer program during the last week of May 1997, that will automatically send notifications of subsequent defaults to primary contractors on its Certificate Requestors/Notice Requestors screen. According to the Executive Director, "[t]his programming change was moved into production status on May 29, 1997." This will move the Division one step closer to full implementation of the law.

The Executive Director plans to modify the computer program to send notifications of ***delinquency status*** to notice requestors as well. While the statute only requires the Division to send notifications of ***default status***, notifying primary contractors at the less severe *delinquency* stage will serve to improve the Division's collection efforts and give primary contractors more time to coax subcontractors into compliance. The Legislative Auditor commends the Executive Director for this innovation.

To obtain full compliance with the law, the Division must enforce the statute by pursuing collections from primary contractors. Whether or not the Division has a statutory duty to seek out *unregistered* primary contractors is unclear as the statute is written. However, the statute clearly *permits* the Division to pursue collections from unregistered primary contractors. The Legislative Auditor asserts that the Division must dedicate resources to locating unregistered primary contractors in ***all default cases which show potential for primary contractor liability recoveries*** to avoid providing a disincentive to registration. From a public policy standpoint, the success of the law is contingent upon broad enforcement. With a Workers' Compensation unfunded liability of $2 billion, the State can little afford to eliminate any avenue of capturing defaulted obligations.

RECOMMENDATIONS

Recommendation 1

The Workers' Compensation Division should come into full compliance with West Virginia *Code* §23-2-1d by August 31, 1997. The Division should take special care to ensure that unregistered primary contractors are sought and that employer account balances are audited.

APPENDIX A

West Virginia Code §23-2-1d
Primary Contrator Liability Law

§23-2-1d. Primary contractor liability; definitions; applications and exceptions; certificates of good standing; reimbursement and indemnification; termination of contracts; effective date; collections efforts.

(a) For the exclusive purposes of this section, the term "employer" as defined in section one of this article shall include any primary contractor who regularly subcontracts with other employers for the performance of any work arising from or as a result of the primary contractor's own contract: *Provided,* That a subcontractor shall not include one providing goods rather than services. In the event that such a subcontracting employer defaults on its obligations to make payments to the commissioner, then such primary contractor shall be liable for such payments. Notwithstanding the foregoing, nothing contained in this section shall extend or except to such primary contractor or subcontractors the provisions of sections six, six-a or eight of this article. This section is applicable only with regard to subcontractors with whom the primary contractor has a contract for any work or services for a period longer than thirty-days: *Provided, however,* That this section shall also be applicable to contracts for consecutive periods of work that total more than thirty days. It is not applicable to the primary contractor with regard to sub-subcontractors. However, a subcontractor for the purposes of a contract with the primary contractor can itself become a primary contractor with regard to other employers with whom it subcontracts.

(b) A primary contractor may avoid initial liability under subsection (a) of this section if it obtains from the commissioner, prior to the initial performance of any work by the subcontractor's employees, a certificate that the subcontractor is in good standing with the workers' compensation fund.

(1) Failure to obtain the certificate of good standing prior to the initial performance of any work by the subcontractor shall result in the primary contractor being equally liable with the subcontractor for all delinquent and defaulted premium taxes, premium deposits, interest and other penalties arising during the life of the contract or due to work performed in furtherance of the contract: *Provided,* That the division shall be entitled to collect only once for the amount of premiums, premium deposits and interest due to the default, but the division may impose other penalties on the primary contractor or on the subcontractor, or both.

(2) In order to continue avoiding liability under this section, the primary contractor shall request that the commissioner of the bureau of employment programs inform the primary contractor of any subsequent default by the subcontractor. In the event that the subcontractor does default, the commissioner shall then notify the primary contractor of the default by placing a notice in the first class United States mail, postage prepaid, and addressed to the primary contractor at the address furnished to the commissioner by the primary contractor. Such mailing shall be good and sufficient notice to the primary contractor of the subcontractor's default. However, the primary contractor shall not become liable under this section until the first day of the calendar quarter following the calendar quarter in which the notice is given and then such liability shall only be for that following calendar quarter and thereafter and only if the subcontract has not been terminated: *Provided,* That the commissioner shall be entitled to collect only once for the amount of premiums, premium deposits and interest due to the default, but the

commissioner may impose other penalties on the primary contractor or on the subcontractor, or both.

(c) In any situation where a subcontractor defaults with regard to its payment obligations under this chapter or fails to provide a certificate of good standing as provided for in this section, such default or failure shall be good and sufficient cause for a primary contractor to hold the subcontractor responsible and to seek reimbursement or indemnification for any amounts paid on behalf of the subcontractor to avoid or cure a workers' compensation default, plus related costs including reasonable attorneys' fees, and to terminate its subcontract with the subcontractor notwithstanding any provision to the contrary in the contract.

(d) The provisions of this section are applicable only to those contracts entered into or extended on or after the first day of January, one thousand nine hundred ninety-four.

(e) The division may take any action authorized by section five-a of this article in furtherance of its efforts to collect amounts due from the primary contractor under this section.

APPENDIX B

Letter from Executive Director Letter from Executive Director of the Workers' Compensation Division

West Virginia Bureau of Employment Programs
• Job Service • Job Training Programs • Labor Market Information
• Unemployment Compensation • Workers' Compensation
an equal opportunity, affirmative action employer

May 9, 1997

Mr. Antonio E. Jones, Ph.D.
West Virginia Legislature
Performance Evaluation and Research Division
Building 5 Room 751A
1900 Kanawha Boulevard, East
Charleston, West Virginia 25305

RE: West Virginia Code §23-2-1d(b)(2) Primary Contractor Liability

Dear Dr. Jones:

Since 1993 the Workers' Compensation Division has implemented compliance with West Virginia Code §23-2-1d (primary contractor liability) on a gradual basis as the Division's ability to properly administer the Code has improved. A brief history of the implementation is as follows:

1. The Legacy system was revised to store primary contractor/subcontractor relationships. Additional, more complex, modifications to the Legacy system were not completed due to: (1) the impending implementation of the WCIS™ system, and (2) the questionable accuracy of the employer files stored on Legacy. The Legacy computer system did not allow for the maintenance of accurate employer balances. Accordingly, the Division was hesitant to notify third parties regarding a specific employer's default status since the correctness of the default could not be ensured without an audit of the employer's account. In addition the man-hours capacity to audit each possible defaulted account prior to the scheduled mailing of default letters (a period of approximately five days) would have required a re-direction of efforts away from daily operations and other collection initiatives.

2. Since the conversion to WCIS™, primary contractors who register subcontractors with the Division do receive a certificate of coverage for all such identified subcontractors in good standing. Accordingly, a primary contractor can deduce if a certificate is not received, additional inquiries should be made of the subcontractor with regards to valid workers' compensation coverage.

3. The Division is now attempting to more closely align procedures with the actions specified in §23-2-1d(b)(2). The accuracy of the employer records has increased significantly and reduced the concern regarding improperly identifying an employer as being in default. The MIS staff is adjusting WCIS™ to mail both certificates of coverage and default notices to primary contractors who have registered subcontractors with the Division. The system change should be in place by May 31, 1997.

Workers' Compensation Division
4700 MacCorkle Avenue, S.E., Charleston, West Virginia 25304-1964 • http://www.state.wv.us/bep

The Workers' Compensation Division has undergone great change over the last five years. Implementing §23-2-1d(b)(2) effectively required prioritization based on potential impact to collections, the subsequent reduction in the deficit and the Division's capacity to implement.

We hope this answers your inquiry, if you have additional questions please don't hesitate to call.

Sincerely,

Ed Burdette
Executive Director

Attachment

cc: William F. Vieweg, Commissioner

APPENDIX C

Agency Response

Cecil H. Underwood
Governor

William F. Vieweg
Commissioner

West Virginia Bureau of Employment Programs
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June 6, 1997

Antonio Jones, Ph.D., Director
Performance Evaluation and Research Division
West Virginia Legislature
Building 5, Room 75 1A
1900 Kanawha Boulevard, East
Charleston, West Virginia 25305-0592

Dear Dr. Jones:

Thank you for sharing with us a copy of the Performance Evaluation of the Workers' Compensation Division, which you plan to report to the Joint Committee on Government Operations at the June interims.

We have reviewed the draft report, and are generally in agreement with the substance of the conclusions and findings contained in the report. Our legal counsel advises us that the Statute does not create an obligation on the Division's part to seek out unregistered primary contractors prior to a default of one of its subcontractors. It is legal counsel's opinion that the obligation is to identify a primary contractor of a subcontractor after the subcontractor defaults. As discussed in our exit conference our Division plans to increase our efforts to identify the primary and subcontractor relationships and pursue collections. Previously our information system, WCIS™, did not provide the capability to automatically send notifications of subsequent defaults to primary contractors. A system change has been installed which will provide the default notification at the next default period (July 10, 1997). We also plan to expand our notification process to contractors. System changes are being developed to provide the capability to send notifications of delinquency to primary contractors. The system change will be in place by the next delinquency period (August 15, 1997). It is our hope, if we are able to notify the contractor sooner, we can eliminate default status.

As always we appreciate the professional relationship and recommendations provided during this audit. We remain committed to improving the Workers' Compensation Division for West Virginia's injured workers and employers.

Sincerely,

John E. Burdette, II
Executive Director
Workers' Compensation Division

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